

# A FISCAL CONSTITUTION FOR THE EU: HOW TO SECURE INNOVATIONS AND NATIONAL HERITAGE

**AUKE R. LEEN**

**Leiden University, The Netherlands**

## ABSTRACT

*The French and Dutch “no” against the proposed EU-constitution has many aspects of being a revolution. If it is a fiscal revolution, a better fiscal constitution as part of the total constitution could be the solution. A typical EU-constitution, bearing on the European cultural and political diversity and spread of knowledge among individuals and businesses, must offer the maximum of freedom for national authorities, individual citizens and businesses: a limited government. A fundamental separation over different authorities of the competences regarding the determination of fiscal rules and the power to make policy within the boundaries of those rules could be the answer. Instead of, as was proposed in the draft of the EU-constitution, to decide democratically about the both of them together. The last is also the practice in today’s European Parliament and European Commission. In due course the separate “taxation chamber” can grow into an organ where all legislation in the EU is made independently of the direct use thereof in concrete policies. In this way businesses in order to succeed have to compete since no special favors can be got by lobbying at the EU.*

## INTRODUCTION

After the French and Dutch voted “no” against the proposed European constitution in two referenda in 2005 to speak of a (revised) fiscal constitution of the EU does not seem to be a priority. It seems more opportune first to look at the general lines for possible cooperation between countries; the fiscal constitution is a point of later care. If, however, the “no” of the French and Dutch citizens is a revolution, the truth counts also that at least halve of all revolutions in world history were fiscal revolutions (Nef, 2002, pp. 42-43). A fiscal constitution takes center stage.

It is telling that it is the fiscal policy regarding the decrease in the amount of the Dutch contribution to the EU-budget and the income support of the EU for French farmers on which both authorities do have to hold the line to please their citizens. The situation regarding the stability pact is just as illustrative. The 3% EU-norm of a maximum allowed budget deficit is in fact a standard that no longer needs to be observed and, if observed, has lost its beneficial effect. With the recently revised rules of the stability pact you can always get away with a larger deficit. Larger deficits are allowed if they are temporarily, are exceptional, caused by an economic recession or have not been created by government policies. Moreover, the 3% EU-norm broken by, e.g., France

and Germany openly and Greece and Italy secretly, without punishment by the EU, has lost all positive influence. It is as by raising kids. To say, "O.K, just for once", is fatal. A better fiscal constitution, also, becomes a priority and can direct a general reform of the EU-constitution in order to secure cooperation between countries.

In short, though the Dutch and French government both do pretend that nothing has happened, yet here too rules the historical wisdom that authorities are free to the extent that people can overthrow her. From that point of view the North-Korean authorities do have all the freedom of the world. For the Chinese authorities, however, the power did shift in recent years to the other side of the spectrum. The Dutch and French authorities are still further at that other side. To speak of a fiscal revolution also, does not seem to be too far-fetched. We answer three questions. What basic value is the guiding value of Europe? A value every constitution has to incorporate. What form of constitution does follow and hence which reform of the EU-constitution is necessary?

## **MEN DIFFER IN PREFERENCES AND KNOWLEDGE**

Why does the EU-constitution have individual freedom as one of its basic values? Indeed, it is a good in itself. And hence does give rise to institutions such as the rule of law with its universal and nondiscriminatory application; universal and open franchise; and separation of powers. This means guaranteed protection of person, property, and contract; periodic elections with open entry into competition for political office; and constitutional limits on the extent of governmental action (Buchanan, 2005, p. 1). Individual freedom, however, is also a necessity for our economic order: the market economy. After all, not only, quite visible, the climate and the physical characteristics of the different countries in the EU do differ, but, less visible, though of more importance, also men in their preferences and knowledge do differ. The problem, and the strong point of a market economy, as has been emphasized by the Austrian-born economist Friedrich Hayek, is to make an optimal use of those differences in knowledge (Hayek, 1982, Vol. 1).

Hence the problem in a market economy is not to give the central authorities, be it Brussels or a local government, all the knowledge it needs to pursue a certain policy. The problem is to give each individual all the extra knowledge he needs, mostly in the form of price signals, so he can decide for himself how to pursue his own goals. In this way society does make use of often unique knowledge of local circumstances and preferences that do differ in time. Knowledge that is difficult to centralize. Individuals often do not explicitly know that they do have a certain knowledge or skill before the need arises to actively use it in a certain situation which is of particular interest to them.

## **AUSTRIAN ECONOMICS**

Let us first expand on the knowledge that is needed in a market economy. In other words we are looking at the core of Austrian economics. A form of economic thinking that indeed started in Austria but has presently its main advocates in the US. In Austrian economics knowledge dissemination and the discovery thereof takes center stage. In 1871 Carl Menger's (an Austrian born economist living in Vienna) value theory turned the value theory of the classical economists upside down. The classical (Ricardian) theory held that cost of production determines the normal value of consumption goods. In contrast, Menger's theory held that the value of consumption goods ultimately determines the cost of production. Value is an expression of judgments concerning future usefulness in meeting consumer wants. Prices do not measure the value of a good, they do express it. Hence does follow one of the Austrian fundamentals of taxation, "No tax can be shifted forward". Prices, as we just said, are never determined by costs of production; the reverse is true. Think of it. There is no reason to expect the producer to wait on, e.g., a general sales tax to increase his prices if he could have done so before. Since the selling price is already set at a "maximum"; a rise in costs, e.g., an imposed general sales tax cannot raise the price any further. The price is determined by the total stock in existence and the demand schedule for it on the market. Hence the fact that the sticker price of a product does show a certain amount of sales tax does not prove that it is shifted forward towards the consumer. The price for the producer for a good on the market is not

the market price minus the sales tax. It is just that market price. The price minus the sales tax the producer gets might well have been reduced to allow for the payment of taxes. So it makes the income the producer receives less. Hence a sales tax is an income tax on the production factors (Rothbard, 1970, pp. 88-93).

Israel Kirzner describes modern Austrianism as an authentic extension of Menger's older static subjectivism: a consequent dynamic subjectivism. In modern Austrianism, the two central figures are Ludwig von Mises and Friedrich Hayek. Both authors focus on market adjustment processes. Kirzner, building his theory as Mises and Hayek did, believes that one of the greatest failures of neoclassical (equilibrium) analysis is that it assumes equilibrium (the equilibrium price in demand and supply) is actually brought about. The real problem for modern Austrians is to describe the possible realization of an equilibrium as the result of "the systematic way in which plan revisions are made as a consequence of the disappointment of earlier plans" (Kirzner, 1962, p. 381).

Mises and Hayek made it possible to describe adjustment as a systematic sequence of decisions. Mises's extension of subjectivism was to describe the individual decision unit not only as maximizing, but also as finding out the relevant ends-means relationship. This opened the way for incorporating learning into our understanding of market processes. Hayek's extension of subjectivism was to describe the process as one of learning by discovery. Endogenous change in the ends-means relationship—says Kirzner—is possible with the entrepreneurial element in each individual market participant: alertness. Alertness is "the propensity [...] toward fresh goals and the discovery of hitherto unknown resources" (1973, p. 34). A disequilibrium situation points to market ignorance. From it emerge profitable opportunities that are exploited by alertness. Alertness gives a more realistic image of human action (and hence real choice) and makes possible the description of the market as a unified discovery process. "[The] 'alertness' view of the entrepreneurial role rejects the thesis that if we attribute genuine novelty to the entrepreneur, we must necessarily treat entrepreneurially generated market events as not related to earlier market events in any systematic way. The genuine novelty [...] attribute[d] to the entrepreneur consists in his spontaneous discovery of the opportunities marked out by earlier market conditions (or by future market conditions as they would be in the absence of his own actions)" [...] "[These] entrepreneurial discoveries are the steps through which any possible tendency toward market equilibrium must proceed" (Kirzner, 1985, pp. 11-12).

In the last centuries the goal of a market economy in which everyone aims at his own interests and uses his own knowledge has been a basic economic value in Europe. For James Buchanan this is all a part of the superiority of the Western value system (Buchanan, 2005, p. 1). In the 19th century John Stuart Mill already wrote, "it is now recognized, though not till after a long struggle, that both the cheapness and the good quality of commodities are most effectively provided for by leaving the producers and sellers perfectly free, under the sole check of equal freedom to the buyers for supplying themselves elsewhere" ([1859], 1974, p. 164). John Maynard Keynes spoke in similar words a century later, "The advantage to efficiency of the decentralization of decisions and individual responsibility is even greater, perhaps, than the nineteenth century supposed; and the reaction against the appeal to self-interest may have gone too far" ([1937], 1964, p. 380).

## **A CONSTITUTION BASED ON A PRINCIPLED LIMITATION OF TASKS**

If freedom of choice and free initiative of citizens is the rule, a constitution must contain a principle-based limitation of the role of government in society. This limitation should be two-fold. First, a limitation of the tasks the government can do and second a limitation on the way fiscal policy is to be decided.

For the first we can look at the constitution of the U.S. If the problem is how to establish a limited government, for the citizens in the U.S. two authorities are of interest: the authorities in each of the states and the federal government in Washington. Is that not too much government? No, not if both authorities compete with each other in the sense that they each have their branch of power. A branch, supported by a constitution, and hence can be guarded. As has been said by James Madison, one of the founders of the American constitution, in the U.S. constitution the central authorities do have little and limited and the states do have many and large competences (Carson, 1983; cp. Markman, 2005). The former has powers related to foreign policy and national

defense. The latter has powers related to the criminal justice system and the protection of the family. In the proposed EU-constitution, however, the opposite seems to be the case: there seems to be little that does not fall under the jurisdiction of Brussels. The proposed constitution describes tasks that the EU has to do under all circumstances (e.g., customs, competition and monetary policy, fishing, trade and the internal market policy), tasks that can be appropriated if necessary (e.g., environmental policy and consumer protection) and tasks the EU supports (e.g., tourism).

But power wants more power, all to the good or to the bad. Every possibility, how artificially, will be used to enlarge it. Even by an explicitly described small task for the (federal) central authorities, as described by the U.S constitution, there are many examples thereof. According to the US-constitution, for instance, interstate trade is a task of the federal authorities. Just as the EU-authorities do have a stake in border crossing interests. That, however, is a license for government involvement in approximately everything. Look at what did happen in the US. The federal authorities may not meddle with agriculture in the separate states. Yet---with the rule and power of the authority over interstate trade in hand---it states how many acres in the separate states have to remain wasted. How can the federal authorities motivate this? A farmer did grow grain on his “wasted” land and fed the grain to his cattle. No interstate trade you would say. But did the Supreme Court argue if the farmer did not had grown grain on his wasted land, he would have bought it. Also he influenced the price of grain on the market and so interstate trade (Snyder, 1998).

In general, think of federalism in the US as (1) the division of powers of government between the national government and the states. (2) the separation of powers in which each branch of the national government---the legislative, the executive, and the judicial branch---has distinct responsibilities, yet is subject to the checks and balances of the other branches. And (3) there is the principle of limited government in which the national government is constrained to exercise only those powers set forth by the constitution (Markman, 2005, p. 2).

In short, however, even if there is a clear separation of tasks as in the US, central government often grabs the possibility to enlarge its powers. What then to expect of a description of tasks in the proposed EU-constitution? Tasks that, in principle, are many and are (badly) held in control in a democratic decision-making process? A process in which everyone thinks that other people do pay for a certain policy and changing majorities have to be bought, time and again, with new money to spend. An ever increasing government budget might be expected.

## **POLITICAL AND CULTURAL DIFFERENCES**

Next for economic reasons, cultural and political reasons too make it difficult to have a fiscal constitution in the sense of a democratic process. Fiscal policy and democracy are hard to reconcile. It is an almost impossible combination to ask for. In the middle of the previous century Hayek (1939; cf. Hayek 1949, pp. 255-72) wrote that democracy can only under very restricted conditions be transposed to a supra-national organization. A little later his American counter-ego Milton Friedman said the same. If you apply both ideas to the situation in Europe we have to conclude that the EU is not only missing the necessary homogeneity to form clear policy goals in a democratic way, but it misses as well the stimuli not to waste the money of the EU.

Why is it hard to expect concrete policy goals and fiscal constraint from the European parliament---the most democratic institution there is in the EU? Of course, very general objectives (e.g., prosperity for everyone) will be easy to agree on. After that, however, it becomes difficult. Concrete objectives will be difficult to formulate. The countries of the EU differ too much in culture, history and economic development. Every choice supposes a balancing of the pros and cons. The service directive of the EU is an example thereof. The recently weakened service directive is supposed to show the social face of the EU. No worker from Eastern Europe, however, will be glad with that revised one that should “protect” him from himself. Within a relatively homogeneous country like the Netherlands, however, the original directive would be no problem. Every plumber from the north of the Netherlands is welcome in the south. Likewise the Netherlands is supporting with a low price of gas a national pride: the agriculture of vegetables in greenhouses in the west of the country. Every

Dutchman is willing to pay for it. But the very same solidarity for a Spanish national pride is something completely different. And the other way around!

The solidarity that is necessary for concrete policy is within the EU very tenuous. Even within one country if things do differ like language (Belgium), religion (North-Ireland) or economic development (North and South-Italy) solidarity is hard to find. All of these situations do characterize the situation within the European parliament. Hence, of an (in the future) democratically chosen Chinese parliament with its approximately 3000 members we can expect more priority setting than by the 700 members of the European parliament. China with its fifty minorities but overwhelming majority of almost 95 per cent Han-Chinese is more a unity than the 25 members of EU are.

If a parliament can give no objectives for administration and, hence, also cannot meaningfully be asked for advice, the European Commission remains de facto the administration. Often below the guise that it concerns only a technical affair. But that is hard to maintain. Over a change in policy, no matter how technically it does look like, the parliament belongs to decide. Moreover also the Commission has to do with the various wishes of countries that do make up the members of the Commission.

Large countries, however, will never transfer their economic power to Brussels. The course of events around the reformation of the stabilization pact in the EU is characteristic thereof. It is naïve to expect the same reforms if a few small countries had broken the rules. Therefore it is to be expected the rule, as proposed in the constitution, that if at least ten countries with 65 per cent of the EU-population do agree, a proposal is accepted, will be violated if it should be of a disadvantage to large countries.

The EU, also, has hardly any incentives not to waste money. The best guarantee not to waste money is that the same person both owns and does spend the money (Friedman, [1979], 1981, p. 146). You loan on the penny and sees to it that you do get value for your money. Members of parliaments or commission members, however, do spend others men's money, on behalf of, often again, other men. That is almost a guarantee for ineffective and inefficient spending. Of each member of a local parliament some restraint in spending the taxpayers' money of his own citizens can be expected. But what to think of an Eastern-European member of the EU-parliament who does spend the money of West-European taxpayers at projects in Eastern-Europe? To satisfy the members of parliament of Western-European countries pork-barrel legislation will rise. Not much different as is presently the case in the US. Often the support of congressmen of several states has to be bought with financial presents (pet projects) for their local constituents. In short, we will see more signs along the roads which state, "This project has been realized with the help of the EU". A project, if the country had to decide and pay for itself, it would not have spent the money on.

The referendum over the EU-constitution had also nothing to do with a choice for or against a more liberal or more socialist Europe. The whole point was that policies no matter how good its intentions, that are certainly possible for each of the countries separately, are no option for the totality of the EU. Europe lacks the necessary homogeneity; priorities cannot be set. To transfer authority and hence policy to Brussels has its limits. The pause that has arisen after the refusal of the EU-constitution can become the most fertile period in the history of the EU. A 'no' against the constitution forces authorities to come up with a fiscal alternative.

## **SEPARATION OF POWERS: DETERMINATION OF VERSUS TO ACT WITHIN FISCAL LAWS**

These days fiscal decision-making is mostly based on the rule that policies have to pose as little resistance as possible for the majority that must approve of them. The feeling, often, dominates that someone else pays (Spicer, 1995). In the last four years no member of the US congress had on total voted for a reduction in government outlays. Notwithstanding that the rhetoric to speak of fiscal discipline was on the rise (Dirksen, 2005). Ever growing government tasks and a growing government budget and corresponding taxation are the result. Besides, it is most likely that "rates of government spending will always be higher than the revenue from the taxes legislatures are willing to impose on their constituents" (Buchanan, 2005, p. 2). This since decisions on

the spending side of the budget are to be made independently of the decisions on the taxing side. If, however, the problem is to carry over tasks to supranational authorities, as is the case in the EU-constitution, we do feel best protected if these supranational authorities only can act on the basis of a fiscal framework stated by yet another organ (Nef, 2002).

Which reformation of the EU-constitution is necessary? According to Hayek there has to be established an authority that states the fiscal rules separately from one that within those rules does administrate (Hayek, 1982, Vol. 3, pp. 126-127). The EU, therefore, cannot have a constitution in which the process of democratic decision-making is paramount. A constitution must do more than just indicate how countries and citizens democratically have to come to a decision: if certain constitutional rules are satisfied, everything is well. If the last is the case, the result is that there are in practice no limits to the tasks of the government. Moreover, if a majority has to decide, this does have the effect, time and again, of the organizing of majorities to support a particular policy: interest groups must be satisfied financially, often at the expense of minorities. A growing government budget and state involvement in the economy is the result.

For Hayek fiscal rules have to be general; they must be valid for yet unknown future cases. The specific effects of following the rules often will not be known to us in advance. They are, in other words, not goal-directed rules. Just as the traffic rules are not goal-directed rules. We do drive at the right side of the road and we do stop for red traffic lights. They give to each of us the possibility to reach our own separate goals. We can think of the rule that only proportional taxation is allowed. (As long as the EU does not collect taxes directly from the citizens we do speak of the contribution of the several countries.) It is a rule in which both those who pay absolutely more and those who pay less probably will agree on. The proportionality rule is a principle. A progressive tariff, however, is highly arbitrary. A majority can grant a minority a deduction, the majority itself, however, always must pay the highest tariff. This in contrast to the present situation in which a majority can decide to tax a minority more and split the proceedings thereof among its own members (Hayek, 1960, pp. 176-177). In this way everyone knows in advance which part the expenses, if he votes for a particular policy, he and those who he represents must carry. A distribution the body that makes the policy cannot alter.

## CONCLUSION

If fiscal dissatisfaction in the EU is the result of a process in which majorities do decide, within that framework it can also never be solved. A majority gives differing majority coalitions political authority. A majority that in the proposed EU-constitution by means of the European Commission and the European Parliament does set the fiscal rules as well as does make policy inside those rules. A solution proposed by Hayek is to make a division of the fiscal powers on the basis of principally and constitutionally assigned tasks: a legislative and executive branch of government. The establishment of a separate branch of government that does state the principles of taxation and hence reform of the EU fiscal constitution is necessary.

This means, paradoxically, not more government, but an active limitation of it. In due course the separate “taxation chamber” can grow into an institution where all legislation in the EU is made independently of the direct use in policy thereof. In that way we can do justice to what Ben Franklin, one of the framers of the American constitution, answered when asked what he had given them. “A limited government, if you can keep it!” (Goldwater, 1960, p. 27).

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